January 15, 2019

Mr. Donald S. Clark
Secretary
Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue NW
Suite CC–5610 (Annex C)
Washington, DC 20580

Re: FTC Hearing #8: Competition and Consumer Protection in the 21st Century

Dear Mr. Clark:

Morningstar appreciates the opportunity to comment on the Federal Trade Commission's (FTC or Commission) hearings on common ownership. We welcome the Commission's decision to solicit views on its near- and long-term law enforcement and policy agenda. Morningstar's mission is to help investors reach their financial goals. Because we offer an extensive line of products for individual investors, professional financial advisors, and institutional clients, we have a broad view on the hearings and the potential effects of future policy for investors.

We urge the FTC to develop a framework for evaluating whether the potential costs of concentrated ownership are, in fact, greater than the benefits they provide investors. As Azar et al. conclude, "Which effect prevails is an empirical question."[1] We urge the FTC to consider the perspective of ordinary investors and of the SEC before formulating any policy in this area. We believe that the policy recommendations—such as curbing asset managers from offering large-scale index funds or taking away passive funds' obligations to vote on shareholder proposals—would harm ordinary investors.

Executive Summary

In this letter we will provide Morningstar's analysis on the following issues relevant to the common ownership hearings:

- The data on the exposure to, and benefits of, mutual funds for ordinary investors, demonstrates that any policy shift in this area needs to account for the impact to millions of individuals.
- Alternative explanations better explain abnormal profitability in a number of industries, much more so than common ownership, such as increasingly "wide moats."
- Standardizing mutual fund voting data would be helpful in increasing transparency and empowering third parties to analyze potential pitfalls of common ownership. In making these recommendations, we are mindful of balancing the benefits of reporting with the burdens, particularly to smaller asset managers.

1Azar, J., Schmalz, M., & Tecu, I. 2018. "Anti-Competitive Effects of Common Ownership." Journal of Finance, Volume 73, No. 4 (May). (Azar et al.). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2427345

A. Benefits of Index Funds

Some researchers have recommended dramatic changes to the mutual fund industry to combat potential problems they believe are caused by common ownership. For example, Posner et al. conclude that an institutional investor should own no more than one company in a potentially uncompetitive industry unless the investor owns less than 1% of the market share.[2] Further, they argue that no institutional investor should communicate with top managers or directors of such a firm.[3] We will discuss the investment proposal here and the engagement/voting proposal in Section C.

These proposals would dramatically change index fund operations; they could fundamentally turn them into active funds, eliminating index funds as an option for investors. Furthermore, their impact is not limited to index funds and would affect many active mutual funds as well.

To quantify the costs of such a change, policymakers first need to understand how many people benefit from mutual funds, particularly index funds. More than 50% of Americans have retirement savings accounts, which typically have index mutual funds as components.[4] Of households in the United States, 44.5%, or 56.2 million households, owned mutual funds in 2017.[5]

According to Morningstar's analysis of the 2016 Survey of Consumer Finances, the median household wage income of all working households with exposure to the market—whether through a workplace-sponsored defined contribution plan; an IRA; a brokerage account; individual holdings of stocks, bonds, or mutual funds; or a workplace-sponsored defined benefit plan—was $70,884. This definition covers 69% of the working population. If we do not restrict the analysis to just working households, then 65% of all U.S. households have exposure to the market, and the median income of these households falls to $50,631. In short, because of ordinary investors' dependence on mutual funds, a shift that would disrupt the mutual fund industry would not only affect a small number of institutional investors profiting from concentrated holdings in leading companies, but also many Americans saving for retirement.

Another critical question is the importance to investors of the diversification that common ownership provides. Common ownership is a necessary byproduct of diversifying in a single fund. If a fund has the goal of providing broad ownership of the stock market to achieve diversification, it is necessarily going to hold shares in competing companies. Posner et. al cite Campbell, Lettau, Malkiel, and Xu (2001), which argues that the volatility of not diversifying

2 Posner, E.A., Scott Morton, F., Glen Weyl, E. 2017. "A Proposal to Limit the Anti-Competitive Power of Institutional Investors." Antitrust Law Journal. (Posner et al.). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754

3 Posner et al.

4 Morningstar Analysis of 2016 Survey of Consumer Finances data.

5 Investment Company Institute. 2018. Investment Company Factbook. P. ii. https://www.ici.org/pdf/2018_factbook.pdf

across companies can be mitigated by diversifying across industries.[6] We question the robustness of this finding over time. Presumably, some investors will end up investing in the airline, bank, or technology company that does not perform well or is driven out of business by competitors. Contrary to Posner's expectation that investing in a single company per industry would not harm investors, Morningstar has found that most returns earned by investors can be attributed to the growth of the upper 20% of successful companies—growth many investors would miss if they were in funds forced to choose among leading companies, rather than owning several leaders in a broadly diversified fund.[7]

Posner et al. argue that passive funds could randomly select companies within an industry and that investors could hold multiple funds with overlapping strategies to mitigate this problem.[8] Such a proposal presents complications for investors who are already struggling to understand their investment options and would have large ramifications for the retirement-plan market. Employers who offer 401(k) plans would have to offer new options and would have to provide guidance to employees on how to use them. Further, asset managers would lose the economies of scale that have led to steadily decreasing costs for investors.

Moreover, the benefits of index funds extend beyond the low-cost diversification they offer to investors. Index funds have forced active funds to justify their higher fees and explain their strategies. They have put plan sponsors and IRA advisors under pressure to ensure they recommend active funds whose fees they can justify to their clients. Indeed, the asset-weighted average expense ratio for all funds fell to 0.52% in 2017, down from 0.56% in 2016, according to Morningstar's latest fees study.[9] The asset-weighted average fees for passive funds and active funds were 0.15% and 0.72%, respectively, down from 0.16% and 0.75% in 2016, and 0.18% and 0.77% in 2015.[10] The graph below depicts how the asset-weighted average fees for both passive funds and active funds have decreased since 2000. The low costs of index funds are directly related to their simplicity. Adding another layer of stock selection to the process of indexing will cause fees to go up.

6 Campbell, J.Y., Lettau, M., Malkiel, B.G., & Xu, Y. 2001. "Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk." The Journal of Finance, Vol. 56, No. 1 (February). https://rady.ucsd.edu/faculty/directory/valkanov/pub/classes/mfe/docs/Campbell_etal_JoF_2000.pdf

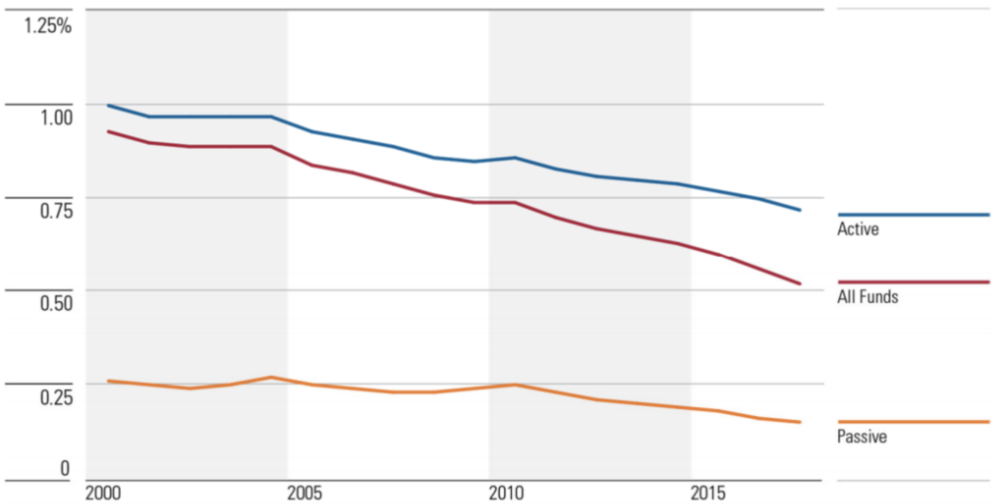
7 Szapiro, A. 2018. "Would Policymakers Target Index Funds? Concentrated Ownership Debate Has Found a Receptive Audience Among Politicians." Morningstar (December/January). P. 18. (Szapiro). http://www.nxtbook.com/nxtbooks/morningstar/magazine_20181201/index.php?startid=18#/20

8 Posner, E.A., Scott Morton, F., Glen Weyl, E. 2017. "A Proposal to Limit the Anti-Competitive Power of Institutional Investors." Antitrust Law Journal. (Posner et al.). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872754

9 Oey, P. 2018. "U.S. Fund Fee Study." Morningstar. P. 3. (Oey). https://www.morningstar.com/blog/2018/05/11/fund-fee-study.html

10 Oey. P. 4.

Exhibit 1 Asset-Weighted Average Fees for Funds Decline 8% in 2017



Source: Morningstar. Data as of 12/31/17.

Thus, to properly perform a cost-benefit analysis on restricting mutual funds from common ownership of competing firms, we would need a clear empirical estimate of the costs to consumers. In the airline industry, Azar et al. estimate that common ownership costs consumers an extra 3% to 7% in ticket prices.[11] But what about other industries? Azar's airlines estimate is a wide range. The two ends of the range (3% and 7%) might yield different answers to a cost-benefit analysis, given the importance of index funds to a broad range of ordinary retirement savers.

Index funds have provided enormous benefits to millions of investors. To justify taking those benefits away, common ownership would need to have a big impact on competitive behavior, much bigger than the 3%-7% price impact that the airline paper found.

Even if an increase in common ownership led to less competition, it makes more sense to address it through traditional antitrust actions than by placing onerous limits on diversification that would effectively dismantle large index funds or voting rights.

B. Problems With Causal Inferences

Four things must be true for common ownership of competing firms to have an anticompetitive effect:

11 Azar, J., Schmalz, M., & Tecu, I. 2018. "Anti-Competitive Effects of Common Ownership." Journal of Finance, Volume 73, No. 4 (May). (Azar et al.).

1) Firms with common owners would be more profitable individually if they competed more aggressively than they do currently.

2) Corporate managers do not have proper incentive to act in their own firm's best interests.

3) Managers prioritize common owners' interests over other shareholders.

4) Common owners apply less pressure on managers to deliver strong performance than investors who only own one stock in an industry (concentrated investors).

Only the last assumption is credible—at least for institutional investors. Because the other three are not, common ownership should have no bearing on competitive behavior or consumer prices.[12]

It is not always in a firm's individual interest to compete more aggressively because actions designed to take market share away from competitors, like price cuts and cutting-edge innovation, often elicit a competitive response that could hurt profits. For example, if American Airlines cuts fares on a route, its competitors will likely follow suit, leaving American (and its competitors) in a less-profitable position. When it is not in a firm's individual interest to compete more aggressively, the mix of common and concentrated investors should have no effect on firm behavior because these investors' interests would be aligned—both groups would prefer less competition. That does not mean that firms behave the same as they would if they were part of a cartel, just that they would not necessarily compete more aggressively if common owners were out of the picture.

As long as managers have incentive to maximize their own firm's value—as most do—an increase in common ownership should not lead to less competitive behavior. It is a stretch to presume that a firm would compete less aggressively to help its competitors, if doing so meant sacrificing its own profitability. Corporate managers are going to do whatever they think will maximize their own wealth, even if common owners are not applying as much pressure for them to do that as concentrated investors.

Corporate managers' fiduciary obligation extends to all their shareholders. As a result, even if common owners have a vested interest in reducing competition in a manner that is inconsistent with maximizing the value of the firm, it is not clear that managers would favor their interests over shareholders who do not own any of the firm's competitors. Doing so would violate the firm's fiduciary obligations.[13]

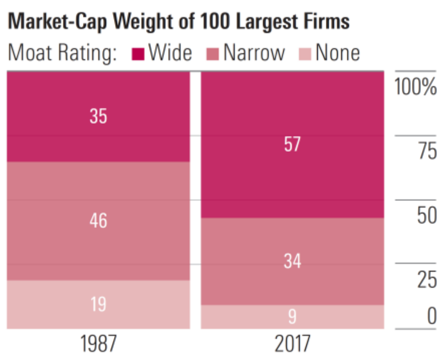
12 Bryan, A. 2018. "Much Ado About Nothing: The Impact of Diversified Funds on Competition." Morningstar. (Bryan.). https://www.morningstar.com/articles/843172/much-ado-about-nothing-the-impact-of-diversified-f.html

13 Bryan.

Undeniably, firms have been enjoying strong profitability recently. This result, however, is not necessarily due to common ownership. There are other sources of anticompetitive behavior.

Morningstar's analysts have found strong evidence that supports an alternative explanation to common ownership as to why companies have become abnormally profitable recently: There are more companies with wide economic moats today than in the past.[14] These firms operate in industries with high barriers to entry and thus can charge higher prices. The graph below depicts a growing share of the aggregate market cap of the 100 largest firms among companies with Wide Economic moats.

Exhibit 2 Moat Heavy
The largest 100 firms have more wide moats



Source: Morningstar.

An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time, with economic profits defined as returns on invested capital over and above the estimate of a firm's cost of capital, or weighted average cost of capital. The size of this moat is determined by five firm factors: intangible assets, switching costs, network effects, cost advantage, and efficient scale.[15] The larger the moat, the more likely it is that a company can avoid competition.

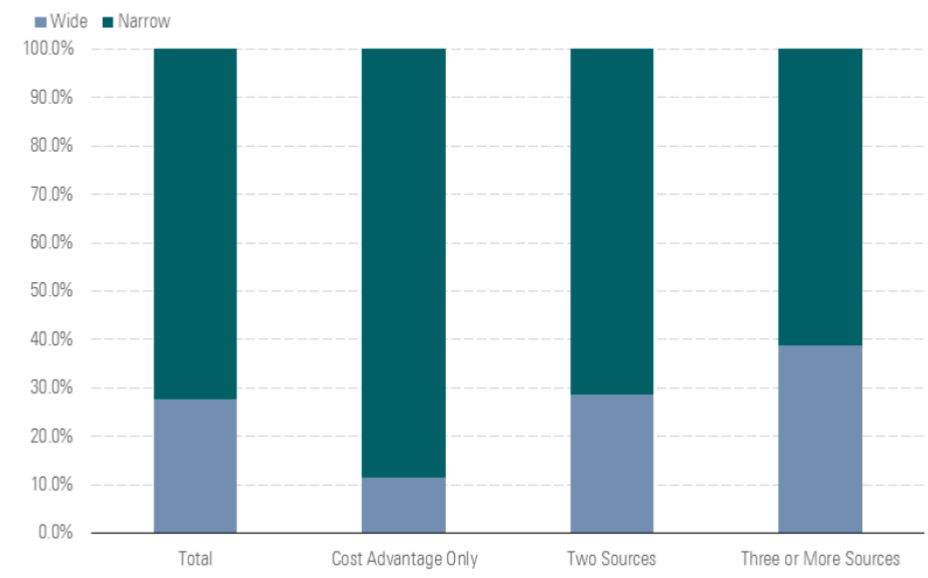
A firm with no moat will see its normalized returns converge toward the firm's cost of capital more quickly than firms that do have moats. The companies with moats are classified as either having a "narrow" or a "wide" moat. Firms with a narrow moat are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. A firm's moat trend is positive when its sources of competitive advantage are growing stronger; stable where there are no anticipated changes to

14 Conover, D., Holt, M. 2018. "Abnormal Profitability: More Moats, More Profits." Morningstar (December/January). P. 30. (Conover et al.). https://www.morningstar.com/content/dam/marketing/shared/research/foundational/858713-MoreMoatsMoreProfits.pdf

15 Morningstar. 2015. "Morningstar Equity Research Methodology." Morningstar. P. 1-2. ("Morningstar Equity Research Methodology"). http://news.morningstar.com/pdfs/705988.pdf

competitive advantages over the next several years; or negative when there are signs of deterioration.[16] Companies with multiple sources of competitive advantage should have wider moats and generate better fundamental performance than those with just one.[17] The graph below depicts how the percentage of companies with wide moat increases as the number of sources of competitive advantage increases.

Exhibit 3 Competitive Advantage Tends to Strengthen with Multiple Moat Sources
Distribution of wide and narrow cost advantage moats by number of moat sources



Source: Morningstar Direct. Data as of Sept. 21, 2017.

Morningstar has analyzed all of these factors and how they have evolved over time, and is happy to share its research with the Commission.

C. Voting Recommendations

We now consider Posner's second recommendation—that passive investors not engage in voting—which we believe will harm ordinary investors and weaken the U.S. financial system. First, we do not know how this remedy relates to the harm being alleged. Shareholder votes do not relate to pricing and, indeed, any kind of collusion on pricing between competitors is already prohibited and penalized under the antitrust laws. If there is some indirect effect on price through the directors and managers being voted on, we see no evidence of a relationship here between engagement or voting and product pricing.

16 "Morningstar Equity Research Methodology." P. 1-2.

17 Hodge, M., Caldwell, P., Compton, E., Davuluri, A., & Wu, M. 2017. "Economic Moat Source Series: Cost Advantage, Analyzing the Prevalence, Modes, Strength, and Limits of the Cost Advantage Moat Source." Morningstar. P. 42. (Hodge et al.).

In addition to the fact that no need exists for this remedy, we think that such a remedy could be harmful. Investors already have very little engagement with their portfolio companies. The engagement and voting of passive managers give some voice, albeit an imperfect one, to shareholders.

Several proposals have been discussed at the hearings regarding the transparency of voting records. Currently, all mutual funds have to file their voting outcomes with the SEC in Form NPX.[18] We support this disclosure and encourage the SEC to standardize the format of this disclosure to facilitate third-party analysis that could inform investors about trends and comparisons in voting across asset managers. If asset managers want to compete based on shareholder values as well as money management, we think that the market should further this type of competition.

We do not recommend, however, expanding disclosures to parties to whom these requirements have not thus far been applied, for example, the recommendations of proxy advisory firms, the votes of pension funds, and others whose voting records do not have to be disclosed. We note that this lack of disclosure does lead to incomplete data and caution that the common ownership research, limited to mutual funds, should be interpreted as just that—research only on mutual funds and not encompassing investments through pensions, separate accounts, and other vehicles. However, we think that expanding reporting at this time would be very burdensome, and that the first step is to improve current disclosures and make them more useful to researchers. We encourage the FTC to work with the SEC to make the filings useful for researchers at both agencies and the public. To this end, we appreciate the participation of Commissioner Jackson in the FTC hearings and agree with his point that policymakers "need to be very wary of the emerging evidence that there might be an anticompetitive effect here." We also share his judgment that "We're at the beginning, rather than the end, of that conversation as a matter of optimal policy."

We appreciate the opportunity to comment on common ownership. If you have any questions on our comment letter, please feel free to contact:

Aron Szapiro at aron.szapiro@morningstar.com or (312) 696-6074
Jasmin Sethi at jasmin.sethi@morningstar.com or (617) 501-5446.

Sincerely,

Aron Szapiro
Director of Policy Research

18 SEC. 2003. "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies." (April 14) https://www.sec.gov/rules/final/33-8188.htm (Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies).

Morningstar, Inc.

Jasmin Sethi
Associate Director of Policy Research
Morningstar, Inc.

cc:

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission

The Honorable Robert J. Jackson Jr.
Commissioner
Securities and Exchange Commission